Joint ventures with the People's Republic of China: a primer for Canadian business

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NOTE

This report was prepared with information available as of July 1, 1987. Readers should bear in mind that the economic and legal systems in China are evolving at an often dramatic rate. Developments may render information contained herein obsolete at short notice. Expert, up-to-date advice should always be sought before making any investment in China.

Introduction

Some eight years have passed since the introduction, in July 1979, of China's ''open door'' policy and the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment, known as the Joint Ventures Law (JVL). Over the years, the People's Republic of China (PRC) has approved more than 7 000 joint ventures. Nevertheless, many foreign investors are still unsure about what they are and what they entail. How does one establish a joint venture? How do they function? What are the problem areas? How much of the commitment must be made for what return on investment?

This primer attempts to answer some of these questions, raise some additional ones and provide the potential investor in a Chinese joint venture with a broad overview of the many issues and complexities involved.

The perspective here is Canadian throughout, whether explicitly stated or not. Many points are drawn from interviews and correspondence with dozens of Canadian firms, either active in Chinese joint ventures or pursuing them, and a source list at the back provides references within Canada for further information.

It is hoped that this primer will help you, the prospective investor, to undertake further research and interviews of your own. Ultimately the best advice that can be given is the following: be diligent, be patient, recognize the long-term commitment required and be aware of what you are getting into. A little time spent going through these pages should help with the latter.

I. What is Meant by "'Joint Venture'"?

The Legal Setting

Until 1979, China did not have much of a legal system by Canadian standards. Chinese legislation was almost as scarce as the number of trained lawyers in the country. The reason for this lies in the philosophy upon which the People's Republic was founded.

To the Chinese, the Canadian legal and, to a large extent, commercial system could not be more foreign. Theirs is a system based on "equality and mutual benefit," a phrase familiar to anyone who has had dealings with the Chinese, and the underlying principle of their joint venture legislation. Negotiation, mediation, conciliation: these are the ways the Chinese prefer to settle disputes. They believe in using the courts only as a last resort when all else has failed.

Some things have changed. Since 1979, the Chinese have passed more than 200 new laws and regulations, mostly in the commercial/economic field. These developments, remarkable for such a short period of time, were brought about in response to demands from Western investors for a more secure legal footing in China. At present, intensive training of new lawyers is a top educational priority, and the number of certified lawyers and court facilities in the country is on the rise.

But, even though many Chinese regulations and laws have incorporated significant portions of capitalist legal doctrines and principles, theirs is still a resolutely socialist system. Jurisprudence, or decisions based on past judgements and practice, still does not exist. Foreign lawyers, in contrast to accountants (a notable professional exception), are not allowed to practise in the country. The courts are still viewed as avenues of last resort and "equality and mutual benefit" reigns supreme as the operational maxim for commercial dealings. Furthermore, the Foreign Economic Contracts Law (1985) states that Chinese law is to govern all foreign contracts. Canadian business people should keep all this in mind, whether considering joint ventures from a legal perspective or looking down the road at dispute resolution in China.

Joint Ventures in General

Generally speaking, a joint venture is a form of co-operation between previously separate entities, who contract to undertake a specific objective in a specified manner. This involves the formation of a new corporate entity, the "joint venture" (JV), which, among other things, may take on a distinct legal character. The JV may be organized in a variety of ways but, at least in theory, the objective of mutual benefit (if not equality) is the same in all cases. The JV should offer distinct advantages to each partner for them to even contemplate the scheme, a point which Chinese firms are increasingly emphasizing to potential foreign partners.

The JV entails the following legal documents, both in China and in Canada. There is (i) the preliminary agreement, which details and resolves most of the

issues; (ii) a JV contract; and (iii) the Articles of Association. Essentially, the contract details the objectives and the overall scope of the arrangement, including the registered capital and responsibilities of each party to the JV, while the Articles of Association provide the organizational framework for management, structure, etc. According to the JVL Regulations, if the JV agreement is in conflict with the contract, it is the contract which shall prevail.

This primer will examine three types of joint ventures:

1) contractual JVs
2) equity JVs
3) hybrid JVs

On certain issues, differences among them are non-existent, while on others, substantial. You will need to carefully consider the respective merits and drawbacks of each type of venture to choose the most likely path to success.

Contractual Joint Ventures

Contractual joint ventures, otherwise referred to as co-operative enterprises and co-management ventures, entail the creation of a business enterprise to perform a specific activity over a specific period. Virtually anything, barring that which would contravene existing legislation, is a possible subject for negotiation and inclusion in the contract. The end result should be a document which clearly delineates the respective rights and obligations of each party.

The flexibility of the contractual joint venture is apparent when it is compared with the equity joint venture, which is governed by a relatively large body of Chinese legislation. For example, a contractual JV does not require that equity contributions by each partner be strictly evaluated and a corresponding distribution between the two agreed on. (You shall see in a later section that this is required in equity JVs and is, therefore, a major problem with them.) If indeed an equity ratio is determined under a contractual JV, the profits or losses need not later be apportioned accordingly. This is a significant benefit to foreign partners who wish to realize disproportionate returns on their capital contributions during the early years of the JV. To many firms, the shorter payback period on their initial investment that a contractual JV provides is a deciding factor in embarking on one.

Under a contractual JV, a clear separation between the corporation entities remains, with each paying its own taxes, bearing its own liability for losses, etc. The JV does not become a limited liability company and is not a separate legal entity under Chinese law. Contractual JVs, are, therefore, more akin to the traditional Western concept of a joint venture, i.e., a purely contractual arrangement along the lines of an unincorporated association.

Since they are not separate legal entities under Chinese law, contractual JVs must have a joint governing body preside over the management of the company, rather than a board of directors. Also, each party is responsible for the debts of the JV in relation to its pro rata share of the venture.

Many companies consider the freedom to negotiate a very specific arrangement without the hindrance of government legislation to be the major attraction of a contractual JV. Others see this as the greatest liability. Because of the paucity of Chinese economic legislation, and their desire for as much legal and political protection for their investments as possible, some firms far prefer the more solid foundation of the equity JV. Which kind of venture is preferable will depend on the specific case in question.

Legislation regarding contractual JVs has been in the draft stage in China for some years and will probably be completed in the near future. The legislation is tentatively entitled ''The Chinese Foreign Co-operatively Run Enterprise Law of the PRC.'' Companies currently in a contractual JV or close to completing one may rest assured, however, that, as the Foreign Economic Contracts Law of early 1985 states, subsequent legislation will not interfere with JV contractual rights.

Finally, equity and contractual JVs are significantly different because of the different tax regimes under which they operate. Contractual JVs are taxed under the Foreign Enterprise Income Tax of the PRC (1982). (The taxation issue is discussed in more detail later in this primer.)

Equity Joint Ventures

The Chinese government considers equity joint ventures the preferred way of attracting foreign investment to the country. In July 1979, the JVL's 15 Articles created the framework for how foreign investment was to enter China.

In September 1983, the Implementing Regulations for the JVL were proclaimed. These Regulations, with 118 Articles, had the stated goal of facilitating the implementation of the JVL and spelled out in greater detail how joint ventures were to operate.

Equity joint ventures have four main characteristics:

1) pooled assets (equity)
2) shared profits or losses according to the respective equity contributions, subject to
3) the formation of a limited liability company with
4) joint management

In an equity JV, both partners negotiate the formation of a new legal entity, the actual joint venture company. This distinct legal character bestows upon the equity JV some important attributes, including the right to contract on behalf of itself. Very often the new company's name will be a hyphenated combination of the companies to the partnership, but it need not be so.

Equity or Capital Contributions

The main difference between an equity JV and a contractual one is that in an equity JV documentation of each party's capital contributions is mandatory. From these contributions an equity ratio is then determined, e.g., 49 per cent, Canadian firm; 51 per cent, Chinese, etc. Theoretically, a JV could have an equity breakdown of 99 per cent to 1 per cent, although this is unlikely. There are a few exceptions to the JVL guideline that foreign partners should ''generally'' contribute not less

than 25 per cent of the total equity. But usually, the Chinese seek a foreign contribution of at least 40 per cent.

Equity may be contributed in the form of cash, equipment and other materials, technology, buildings, right-to-the-use-of land fees, and industrial property rights. Canadian investors should note that a capital valuation may not be included for a foreign party's contribution in the form of service or training of personnel, which is usually involved in JVs, and often at substantial cost to the foreign firm. Adequate compensation would have to be negotiated and provisions covering it included elsewhere in the contract.

Other stipulations with respect to capital contributions abound: for example, machinery, equipment and other material may be contributed by the foreign party only if they cannot be reasonably sourced within China; any technology that is transferred should be ''truly advanced and appropriate to China's needs'' and capable of contributing to China's economy in at least one significant manner; and equity contributions must be denominated in a single currency, usually the local currency, the renminbi (RMB).

Note that the capital contributions and their valuation are often the focus of intense negotiations and disagreement between the parties and may be determined independently by a third party if the JV partners agree. Ultimately, the relevant authorities within the Chinese government have final say.

Chinese concern over the rising debt loads of many JVs led to guidelines on debt/equity contributions in January 1986. These were replaced, in March 1987, by the Interim Regulations of the State Administration for Industry and Commerce on the Ratio of Registered Capital to Total Investment for Chinese-Foreign Equity Joint Venture Enterprises. The new regulations, which apply equally to contractual JVs and to wholly owned subsidiaries, reduced the level of equity required for smaller projects and raised the level for larger ones. They are summarized in the following table.

Value of Investment	**Maximum Permitted Debt/Equity Ratio**	**Minimum Capitalization**
(in US$)		(in US$)
3 million or less	70 per cent equity	—
3 to 10 million	50 per cent equity	2.1 million
10 to 30 million	40 per cent equity	5 million
30 million	33.3 per cent equity	12 million

The equity breakdown is crucial to the following considerations:

1) how the profits (or losses) will be split between the partners;
2) the respective representation in the top management level or board of directors;

3) major tax considerations, especially upon dissolution of the JV; and
4) division of capital upon dissolution of the JV.

Although the Chinese drive a hard bargain on the equity valuations, they take the view that the JV must be given the best chance possible to compete on its own for the sake of both partners. Again, the principle of ''mutual benefit and equality'' is at work.

The Board of Directors

As a separate legal entity under Chinese law, the equity JV is managed by a board of directors with a minimum of three members. Heading the board is the chairperson, who is, by virtue of the position, the legal representative of the joint venture. The JVL explicitly states that the chairperson must be Chinese, and further recommends that one or two foreigners be appointed as vice-chairpersons. This has usually been the case in practice, although the composition of the board is a matter for negotiation between the parties, and often there is flexibility on this issue. In addition, when the composition of the board is finalized, each party retains the right to appoint nominees to and remove them from the board.

It has also been standard practice to appoint a foreigner to the position of general manager. It is his or her responsibility to manage the day-to-day operations of the company. In many instances, a Chinese deputy general manager is appointed to receive on-the-job training and in the process, is groomed to later on assume the general manager's position.

The board of directors makes decisions (preferably by consensus) on all major issues to the JV. Certain decisions require unanimous approval of the board, e.g., amendment of the Articles of Association, termination and dissolution of the JV, mergers, etc. A notable exception to the board's sphere of authority is the employment and discharge of workers. This issue is regulated by Chinese law and by the detailed labour contract that must be drawn up along with the JV contract. Once again, the JVL reiterates that decisions made by the board of directors should be undertaken in the spirit of ''equality and mutual benefit.''

Labour Relations

Workers will either be recruited by local authorities or by the JV management with the consent of the local authorities. Although the ''22 Articles'' of October 1986 and labour provisions issued in November 1986 assure foreign enterprises of their ''right of autonomy'' in the hiring of personnel, full autonomy is not yet a reality. Interestingly enough, the merit principle is specifically included in the JVL as the basis for hiring and paying workers. The qualifications of prospective employees are to be assessed through examinations, and wage and incentive systems are to be formulated on the basis of ''each according to his work and more pay for more work.''

As no country-wide labour legislation exists in China, the labour contract must specify a multitude of details, including conditions for dismissal, working hours, wages, vacations, etc. Certain Special Economic Zones (SEZs), however, do have provisions concerning specific labour and management policies.

The JV must pay various expenses for its Chinese workers, including insurance, medical fees, staff and social welfare, union fees and a reserve contingency account. Except in the case of very small JVs (a term that is not defined), all JVs must have a trade union that signs the labour contract on behalf of the workers. The union can object to the dismissal of any of its workers, at which time it has the right to enter into conciliation procedures with the board of directors of the JV.

Workers can be dismissed when a ''surplus'' condition exists or when workers are deemed unsuitable after training. In effecting a dismissal, the JV must pay compensation, carry out the procedure in accordance with the labour contract, and advise the relevant authorities. In most instances, the approval of the authorities is also required.

The JVL Regulations require that companies try to upgrade the relevant skills of the workers. This requirement applies for an undetermined period, from the point of hiring onward, during which any dismissal is precluded. The worker must be given a ''suitable'' term within which inefficiency, low productivity, etc., might improve with ''adequate'' training. Some foreign firms have identified labour training as a major problem area in their Chinese JV. They either underestimated the amount of time required for training, or the number of Chinese workers to be trained.

Finally, the board of directors determines wages but must set them at 120 to 150 per cent of those paid to workers in an equivalent state-owned enterprise.

It is unclear whether the labour regulations of the Special Economic Zones apply to joint ventures. It appears that the SEZ rules, which allow the employer greater influence in the selection process, will take precedence in a conflict.

Procurement of Raw Materials

Chinese authorities expect the JV to give preference to local sources in the purchase of ''semi-processed materials, fuels, auxiliary equipment, etc.'' The JVL also sets pricing guidelines for materials and services within the PRC. With two exceptions, the cost of all materials sourced within China is to be the same for JVs as that charged to state agencies. Payment may be made in renminbi. The two exceptions to the rule are (1) the so-called ''six raw materials'': gold, silver, platinum, petroleum, coal and timber; and (2) imported goods that would otherwise be exported by China. For these two classes of exceptions, international market prices are to apply.

Goods and services must be purchased through the appropriate state agency or ministry. There is no guarantee that these will always be available domestically in adequate supply and of the required quality. Therefore, if a JV intends to make major purchases, these will have to be provided for in the state plan.

This can pose both advantages and disadvantages to the JV. On the one hand, the JV should try to guarantee as much as possible in terms of supply, pricing, quantity, etc., for the sake of better forecasting and planning. On the other hand, it might become obligated to purchase either substandard or poor quality goods. Either

way, the JV will have to submit an annual plan and apply for the necessary import and export licences every six months for those materials, equipment, machinery, etc., that fall under the state plan. According to the ''22 Articles'' of October 1986, however, ''enterprises with foreign investment'' are not required to obtain import licences if the goods in question are needed for the production of an export contract. The deferment and reduction of taxes on the goods is also possible.

Product Marketing

In the case of export sales, the JV is free to establish a price for its goods and to market them as it sees fit. Domestic sales, however, are a different story.

If products are subject to the state plan, the JV must sell a predetermined number of the goods to the relevant state agency. Once that level or quota has been reached, the JV may sell any excess independently. For the most part, prices paid for domestic sales will be state-set and will be quoted in renminbi with payment due in the same. The Chinese authorities have sometimes been flexible on this matter during negotiations, especially in allowing different prices based on the quality of goods. In some cases, JVs have been permitted to ask for a domestic price based on an international market evaluation of the goods.

Fundamental Changes to the Joint Venture

As already mentioned, the life span of the JV is limited by its contract. The Chinese set limits designed to give them time to gain sufficient training and experience to keep operations running without undue foreign involvement and to allow foreign investors time to realize adequate returns on investment.

The nature of the JV will determine how long it is destined to continue. Generally speaking, 15 years is an average life span, with an industry breakdown as follows:

Hotel and service projects	10 years
Light industrial projects	15 years
Heavy industrial and resource industry projects	25 to 30 years

Note that the average life span of JVs seems to be getting longer. In the first few years after the JVL, the average was 10 to 12 years, and a 30-year ceiling was mandatory. Article 100 of the JVL Regulations revised this to remove the 30-year ceiling, permitting high-technology projects, large-scale projects or those that manufacture goods in demand internationally to be extended to more than 50 years.

JV contracts usually provide for the renewal of the venture if the parties see fit to do so. Ministry of Foreign Economic Relations and Trade (MOFERT) approval is required.

The JVL addresses the possibility of one party wishing to transfer its interest to new or ''third'' parties. This may occur during the course of the JV's operation only on consent of the other JV partner(s).

Contracts also provide for an early termination of the JV under three circumstances: inordinately heavy losses, failure

of one party to abide by its contractual obligations, or ''occurrence of reasons for dissolution stipulated in the JV contract and/or Articles of Association.'' The latter is yet another reason why parties should take the utmost care in drafting the contract. Bear in mind, however, that premature termination of the JV on any of these grounds is still subject to the approval of Chinese authorities.

Finally, note that the PRC has no bankruptcy law, although apparently this too is in the draft stage. The lack of such a law can be problematic if the JV has not outlined liquidation procedures in advance. According to the JVL, these procedures are to be determined by the board of directors, who shall also nominate candidates for the liquidation committee.

Dispute Resolution

In the event that the JV partners cannot settle their disputes by negotiation, they must resort to conciliation before any arbitration may occur. Conciliation can be carried out in one of two ways: within China by the Foreign Economic and Trade Arbitration Commission (FETAC), or outside China using UNCITRAL or International Chamber of Commerce (ICC) Rules. The latter method has been seen as a concession on the part of the Chinese, and has helped allay the fears of many potential investors regarding conciliation.

Should arbitration prove unavoidable, it would normally be carried out by a Chinese arbitral body, although it can also be an arbitral body agreed upon by the parties and specified in the JV contract or Articles of Association. The latter leaves the door open for arbitration in a third country.

The arbitral tribunals within the PRC are FETAC and the Marine Arbitration Commission (MAC), both organized under the auspices of the Chinese Council for the Promotion of International Trade (CCPIT). In most cases, i.e., those which do not involve a purely marine dispute, the arbitration for parties to a JV is conducted by FETAC. Its decision is final, and the award has the force of law in China.

Note that the PRC signed the UN Convention for the Recognition and Enforcement of Arbitral Awards in 1987. Canada acceded to this multilateral convention in 1986, and both countries apply it to differences arising out of legal relationships considered commercial in nature under the respective national laws.

Finally, it is likely that, over the life of the JV, disputes might arise with a third party. Should negotiations fail to produce a satisfactory result, such a dispute would probably be resolved through the extensive system of Special Economic Tribunals in the People's Courts, which were established in 1979.

It must be stressed, however, that parties should draft agreements that state dispute resolution procedures for as many different circumstances as possible, and in language as explicit as possible.

Hybrid Joint Ventures

The hybrid JV is not as common a classification as the contractual or equity JV. Often hybrid JVs are lumped under the contractual JV heading, yet they differ enough from these to present a third JV option to potential investors.

As their name implies, hybrid joint ventures are essentially a cross between contractual and equity JVs. They resemble contractual JVs, but retain the equity JV characteristic of being a separate legal entity.

Hybrid JVs are not necessarily limited liability companies, as are contractual JVs. To become such, the parties need only appoint a board of directors. Hybrid JVs also differ significantly from contractual JVs in how they are taxed. Hybrid JVs currently receive the same preferential tax treatment as equity JVs under the Joint Venture Income Tax Law of 1980, although some people believe that this advantage will disappear with the enactment of the contractual JV legislation. If and when such legislation is implemented, it will remain to be seen whether or not the hybrid JV continues to exist in its current limited, but often valuable, fashion.

II. Major Issues for Consideration

This section takes a look at five of the major issues that you must seriously consider if you are interested in a joint venture with China. It begins by looking at the transfer of technology, then examines foreign exchange, taxation, insurance, and, finally, the selection of a geographic location.

Transfer of Technology

A prime concern for companies involved in technology transfer is whether their interests will be protected under any agreement. Will the technology be restricted to a certain predetermined area, or will it find its way to other locations and end-users? How much support will the company be obliged to provide after the transfer occurs? Will the firm's status as proprietor of the technology always be respected? The JV contract can cover these and other vital issues. Keep in mind, however, that the Chinese have drafted specific legislation addressing these concerns.

Major pieces of legislation include the Trademark Law of the PRC (1983) and the Patent Law of the PRC (1985), as well as the Regulations of the PRC on the Administration of Technology Acquisition Contracts (1985). Furthermore, China joined the World Intellectual Property Organization in 1980 and, more importantly, became a signatory to the Paris Convention for the Protection of Industrial Property Rights in 1985.

Under the Trademark Law, a successfully registered applicant will receive exclusive holding rights to a trademark for 10 years within China. Certain remedies for infringement are also provided. In order to apply for such protection, the company must be based in a country which has concluded a relevant reciprocity agreement with China. Canada has such an agreement in place. Applications must be made through the Trademark Registration Agency of the CCPIT, and applicants can expect an 18 to 24 month waiting period before registration is finalized.

The Patent Law of 1985 provides 15 years of protection for suitable inventions. To qualify as suitable, the invention must be "novel, inventive and practical," and, as no geographic restrictions are attached, the invention must be essentially different from anything inside or outside China. There is no protection, however, in a variety of cases, including "rules and methods of mental activities," "substances obtained by means of nuclear transformation," etc. Companies granted patents must pay annual fees for them. The CCPIT is the official liaison between patent applications and the Chinese Patent Office. Foreign firms may file applications through the China Patent Agency Co. Ltd. in Hong Kong.

Finally, a word of warning: if the invention or process for which the patent was granted is not utilized within three years, a compulsory licence may be granted by Chinese authorities to another firm, in which case a "reasonable fee" will be payable to the foreign patent holder.

Unfortunately, even with the recently bolstered legislation in place, it still

appears that the Chinese have not developed protection for industrial property rights comparable to that afforded in most Western countries.

Foreign Exchange

Joint ventures must open an account with the Bank of China. All incoming and outgoing transactions must be concluded through this account. The Bank of China, one of the country's many specialized banks, is responsible for foreign exchange (forex) banking. Among its many duties are the settlement of international trade and non-trade accounts in foreign currencies, deposits, floating of loans, granting of bank credits and loans, dealing in international monetary exchange, and overseas remittances. JVs will, in fact, have two accounts with the Bank of China, one for domestic currency and one for foreign. According to the JVL, these two accounts must be in balance, and here the problems begin.

At the commencement of the JV, a firm's capital contribution by way of foreign currency is translated into RMB at an exchange rate quoted by the State General Administration of Exchange Control (SGAEC) on the date the payment is made. The SGAEC is the government organ created to administer foreign exchange rules. Throughout the life of the venture, the JV must submit periodic reports and statements detailing its forex status to the SGAEC. The JV must apply to the SGAEC before debiting the forex account.

Many joint ventures run into problems in achieving the required equilibrium in forex. It is difficult to generate enough foreign currency, especially if the product in question does not have a large export market or is produced exclusively for the domestic Chinese market. This problem is compounded when the repatriation of profits (if indeed they exist) becomes an issue.

In January 1986, the Chinese finally issued an official response to the concerns expressed by foreigners for a number of years on the forex issue. The Regulations Concerning the Balancing of Foreign Exchange Receipts and Expenditures of Chinese-Foreign Joint Ventures provided four ways in which JVs could earn foreign exchange:

1) carry out export sales of the product;
2) receive payment in foreign currency from Chinese foreign trade corporations (FTCs) for those goods which would normally be imported, i.e., ''import substitution'';
3) take payment in goods (or purchase Chinese goods with RMB) and then export those goods;
4) if there is more than one JV in China, balance the forex accounts between the two by adjusting their respective surpluses and deficits.

These ''alternatives'' were far from novel; they were but some of the many different schemes proposed by foreign financiers to solve the constant forex problem. Considering that China's precious foreign currency reserves shrank to even lower levels than anticipated during 1985 and 1986, the problem appears to be an ongoing one.

It is significant that the 1986 Rules Concerning the Balancing of Forex squarely

place responsibility for the forex requirements of a JV (and any ensuing shortages) on the shoulders of the authority who approves the contracts. Therefore, companies should be prepared for even tougher and more time-consuming negotiations than ever when hammering out contracts. Foreign companies will have to be very explicit about how they intend to obtain, spend and earn forex.

On termination of the JV, the only precondition regarding remittance of profits is that the venture be wound up in accordance with all legal procedures, which must be carried out under the supervision of the relevant government departments and the SGAEC. Some people point out that language addressing the above is only "permissive," i.e., repatriation may take place if the stipulated conditions are met. No companies have yet reported problems in this area, however.

With respect to the salaries and wages paid individual employees, the JVL regulations stipulate that not more than 50 per cent of their after-tax earnings may be remitted or taken out of the country. This has many implications for careful salary planning and incentive packages for expatriates, although many exceptions have occurred in the enforcement of this regulation.

The crucial point is that, regardless how serious are their foreign exchange problems, the Chinese are governed by their need for foreign investment. More than anyone, they realize their dependence on such a financial inflow, and likewise the dramatic repercussions that would follow should they try to take too much out of the hands that are currently feeding their economic growth.

Taxation

This section will cover some of the highlights and attempt to provide an overview of the very broad and detailed taxation issue.

Two very distinct tax regimes apply to JVs. Contractual JVs come under the jurisdiction of the Foreign Enterprises Income Tax Law which came into effect at the beginning of 1982. Equity JVs and hybrid JVs, on the other hand, have been taxed under the Income Tax Law on Joint Ventures with Chinese and Foreign Investment since September of 1980. The "Joint Venture Income Tax Law" (JVITL), as it is commonly called, was further supplemented by a series of regulations three months later.

The JVITL provides for a basic tax rate for equity JVs of 30 per cent to be paid on the new profits or net income after the payment of all expenses and operating costs. A further 10 per cent of the 30 per cent is then due in local tax, for a total effective tax rate of some 33 per cent. Finally, there is a withholding tax of 10 per cent on any repatriated profits, although the "22 Articles" of 1986 have exempted foreign investors in registered "export enterprises" and "technologically advanced enterprises" from the remittance tax.

A number of tax incentives are offered, including:

1) A newly established JV scheduled to operate for ten years or more may be exempted from paying income tax in

the first two profit-making years and receive a 50 per cent tax reduction in the following three profit-making years.

2) A foreign investor who reinvests his or her profits in China for five or more years, is eligible for a tax refund of up to 40 per cent of the income tax paid on the amount reinvested.
3) If the JV is classified as a low-profit operation, for instance one engaged in farming or forestry, or located in a remote area, it may qualify for a 15 to 30 per cent tax reduction for a period of 10 to 15 years over and above the initial available exemptions.

Note that the right of interpretation for the Income Tax Law and the JVITL has been reserved for the Ministry of Finance, and not the courts.

The tax regime for contractual JVs is markedly different. Foreign companies with ''establishments'' in China are taxed at progressive rates ranging from 20 to 40 per cent. A local income tax at the rate of 10 per cent of the net taxable income then results in an effective tax range of 30 to 50 per cent. No tax is withheld on any repatriated profits.

Many of the tax incentives offered to equity JVs apply to contractual JVs as well. Taxes must be paid on the world-wide operations of the JV, not just income sourced from within China.

Among the many other Chinese taxes that foreign firms should investigate is the Consolidated Industrial and Commercial Tax (CICT), initially adopted in 1958. Best described as a form of sales tax levied at successive stages of production and manufacturing, the CICT is very complex, has many exceptions and has a number of specific applications with respect to joint ventures. Another relatively old, but still active piece of legislation, is the 1950 Industrial and Commercial Income Tax Act. Whether it applies to JVs, however, is uncertain. Personal income tax is based on a progressive rate ranging from 5 to 45 per cent, and, to varying degrees, depends on how long one has been living in China and where the income originated. Finally, pay attention to the various customs duties. Exemptions or discounts are available in certain instances, for example, with imports deemed necessary to the original investment.

Again, confusion exists when new legislation does not specifically override that which it has replaced, or when jurisdictions overlap. This is sometimes the case with the Special Economic Zones and the Coastal Cities. Within them, a flat tax rate of 15 per cent is applicable to all enterprises; there is no withholding tax on repatriated profits; and local taxes may be waived – just some examples of the tax holidays available. Furthermore, Canada and China signed an Agreement in May 1986 to avoid double taxation.

Finally, it might be prudent to weigh the benefits of very sophisticated tax planning against the possible loss of goodwill on the part of the Chinese that might result. A willingness to pay some tax could have long-range benefits for the foreign company. Above all, it should be stressed that companies need expert advice when dealing with the complicated and constantly changing issue of taxation.

Insurance

The JVL stipulates that insurance must be supplied by the People's Insurance Company of China (PICC). This company provides foreign investors with a wide spectrum of domestic coverage for, among other things, war and SRCC (strikes, riots and civil commotion) and for some political risks.

In January 1984, Canada concluded a Foreign Investment Insurance Agreement with China through the Export Development Corporation (EDC). The EDC offers foreign investors insurance against losses ensuing from the risks of inconvertibility, expropriation, war, revolution and insurrection. To be eligible, the proposed investment must be of some economic advantage to Canada and China. Such EDC insurance is not contingent upon there being Chinese coverage in place.

Selection of Geographic Location

Foreign investors can choose to establish JVs in SEZs, the Coastal Cities, or more inaccessible regions that offer greater tax advantages. Transportation and communication links are paramount to some businesses while of secondary concern to others. Guangdong Province offers the advantage of being close to Hong Kong, and, indeed, 80 per cent of the foreign investment flowing into China finds its way into that province. Shanghai and Beijing are fast becoming modern metropolises and have long been recognized as hubs of Chinese commercial and industrial activity. Proximity to raw materials and a suitable energy supply are additional concerns. Keep in mind that the location and size of the investment will determine who the relevant authorities for many of the approval decisions will be. There is no underestimating the importance of this major initial decision.

III. The Process Involved in Establishing a Joint Venture

The usual process for establishing a joint venture can be broken down into a number of steps, many of which involve the submission of forms and documents to the pertinent authority.

Preliminary Negotiations

At this stage, a key consideration in preliminary negotiations will be the selection of the JV partner. (More details can be found in the next section, Major Problem Areas.)

Letter(s) of Intent are Signed

Not legally binding, these documents do what their title implies: they serve as a written notice of both parties' intentions with respect to the general direction of the negotiations.

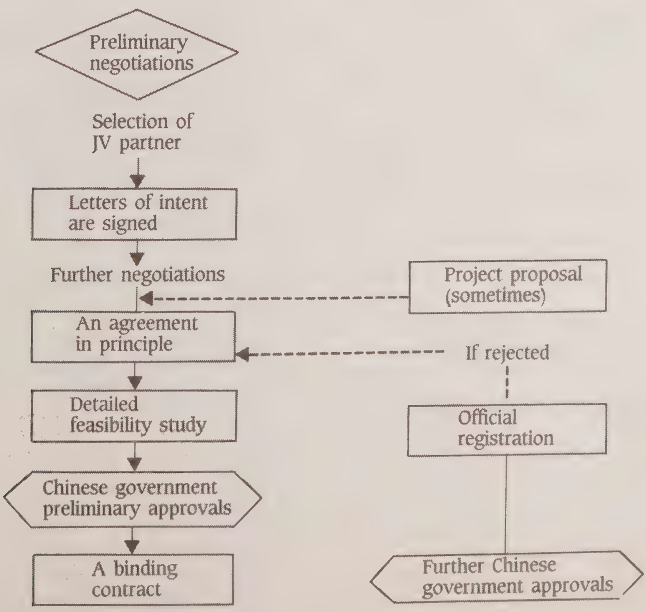
Further Negotiations

During this stage the foreign firm often discovers that the letter of intent was little more than a starting point for negotiations.

An Agreement in Principle

The Agreement in Principle is still a non-binding document, although by this stage the parties should have reached a good understanding on the JV and have ironed out most of the details. The agreement is sometimes preceded by a preliminary feasibility study or project proposal.

The Process Involved in Establishing a JV



Detailed Feasibility Study

The detailed feasibility study allows the individual parties to evaluate the JV's chance of success. It is also a mandatory submission to the Chinese government when seeking formal approval for the venture. The government's intent with this requirement is, apparently, to cut down on the number of unfeasible proposals.

Chinese Government Preliminary Approvals

To overcome this first obstacle along the path to official registration, that of preliminary approvals, the parties must submit the following:

1) the detailed feasibility study;
2) an application form;
3) the JV Agreement in Principle.

These will be handed over to MOFERT, which is the state organ responsible for the initial government approval of the JV. Note that the Chinese partner is responsible for registration of the JV within China, in so far as seeing that the proper documents get to the right place on schedule.

A Binding Contract

Usually a binding contract signifies the conclusion of the negotiating phase between the parties themselves. There is only one more step left to take to become officially registered.

Further Chinese Government Approvals

At this point in the process, the parties must submit the following items in order to obtain further government approvals:

1) the JV contract;
2) the JV Articles of Association;
3) a list of candidates for chairperson, vice-chairperson and the directors;
4) written opinions of departmental government authorities regarding the viability of the venture.

After a maximum three-month waiting period, the relevant government organ must render a final decision. Once the JV receives its official certificate of approval, it has one month to apply for official registration.

Official Registration

The applicants must submit the following when seeking official registration:

1) request for registration;
2) approval certificate;
3) foreign company's certificate of incorporation;
4) feasibility study;
5) if applicable, a verification certificate issued by the government department on construction, specifying that water/power/environmental concerns have been addressed.

The relevant local government for the proposed JV will examine these documents and respond within one month. The response, along with the documentation, will be reviewed by the State General Administration for the Control of Industry and Commerce (GACIC), which

may either reject, alter, or, it is hoped, issue a notice of Approved Registration, which will then mark the official birth of the JV.

How long the whole process may take depends on so many variables that only the broadest of generalizations can be made. Three years, however, would be a realistic time-frame from preliminary negotiations through to official registration.

Traditionally, MOFERT issues the required approvals, although the responsiblity may, under certain conditions, be delegated to "entrusted organs," namely the following:

1) the People's Government of the relevant province, autonomous region or directly administered municipality;
2) a relevant authority;
3) a bureau of the State Council.

The conditions for delegating authority to these organs include dollar limits for the JV above which state permission must be sought; requirements that extraordinary allocations of Chinese raw materials are not needed; the national balance in such areas as fuel, power, transportation and foreign trade export quotas is not affected; and the JV is not of a "strategic" nature. However, the entrusted organ must still report to MOFERT and it is MOFERT that will issue the final certificate of approval.

IV. Major Problem Areas

There are problematic issues in any business investment, be it international or domestic, large or small. Many of these problems will be particular to the specific venture in question, while others are more general in nature. The foreign investor engaged in joint ventures with China faces the unique combination of problems that are discussed below.

Foreign Exchange

Foreign exchange is the single major problem area encountered when doing business with China. The JV requirement for a balance between domestic and foreign currency accounts, and the constant approval needed from SGAEC on all forex transactions right down to the repatriation of profits have already been mentioned earlier. You should take great care to find out what specific state organ (and individual, if possible) is responsible for authorizing the release of foreign exchange to the specific JV.

Forex also ties into the issue of payment in that, due to China's intense desire to conserve foreign currency, it will push hard for a countertrade arrangement. However unpalatable this may be to the foreign firm, in many cases it is necessary in order to conclude the deal.

Capital Contributions

An earlier section has dealt with some of the valuation problems associated with capital contributions and the many implications that follow from the equity ratio. Note that the valuation for the right-to-the-use-of land site is done unilaterally by the Chinese government, with no recourse to any true market valuation for the foreign firm. A frequent Chinese tactic is to have the foreign firm commit itself to a sum for its total capital contributions. The Chinese then value the land site in such a way that the final equity ratio works out to what they were seeking originally. Furthermore, whenever a new land site is needed, valuation negotiations must begin once more. Again, the foreign firm is not allowed to consider its often substantial services and training expenses as a capital contribution. The documentation required to accompany any request for a technology contribution can be considerable.

Identifying the Right Partner

Selecting the proper partner for a JV is, perhaps, the most crucial decision that a foreign firm must make. And it is often a difficult one.

One of the greatest advantages to utilizing the JV approach in China is the credibility a foreign firm gains in having a Chinese partner at its side. It is absolutely essential that the foreign firm find a partner who, among other things,

1) has the authority to negotiate (not something that all Chinese firms have);
2) will prove compatible from an organizational and philosophical point of view to the venture in question, i.e., can be worked with;
3) has clear and assured access to the relevant decision-making Chinese authorities (central, provincial/municipal/autonomous region authorities,

whatever is the case);
4) is fully committed to supporting the JV.

Time and Approval Delays

Two to three years is the usual time needed to conclude a JV. Any JV concluded in less than that is an exception. So much time is needed because of the lengthy approval process of the Chinese bureaucracy. The number of approvals and the governmental level at which they must be obtained might seem to a Canadian to be an overwhelmingly complex process, especially for what seem very minor issues. But keep in mind that the Chinese reach decisions by consensus, and it is rare that any one person on the Chinese negotiating team has ultimate decision-making authority. This is one reason why it is crucial for the Canadian firm to select a Chinese partner that will have as direct access as possible to the relevant authorities within the government. Remember, this need not always be at the central government level – it can be provincial or municipal in some cases – and, also, that you will probably have to deal with a number of different ministries.

Letters of Intent

Don't be misled by letters of intent, but do not dismiss them entirely. They have gradually evolved into a de facto requirement for doing business with the Chinese. A foreign negotiator should never visit China or enter any serious negotiations without drafting something on paper in advance. This can later be turned into a letter of intent if necessary, but in the interim it gives the Chinese something that they can review and show to higher authorities if need be. On the other hand, letters of intent by themselves are non-binding and could easily be described as ''a dime a dozen.'' A far more arduous set of negotiations must be embarked on after a letter of intent is signed and before the conclusion of any JV agreement should even be considered.

Termination of Contract

A major concern upon termination of a JV is the company's valuation, and, thus, the share which the foreign firm may repatriate. It is difficult to know whether or not the PRC will recognize the ''going concern'' or ''goodwill'' value of a firm. Furthermore, it appears that in most cases involving the termination of a contractual JV, the fixed assets of the project are turned over to the Chinese.

The Need for International Experience, Size and Commitment

Your firm should have some international experience before attempting to deal with China. Most foreign firms recognize that China is one of the toughest markets to deal with. The country presents so many unique problems that you need prior experience in order to look after the strictly international aspects of the venture. Most companies feel that size is also a major determinant of success. The protracted length of negotiations demands a major commitment of company resources to the Chinese venture. The time, manpower, travel, etc. involved can result in substantial investment. Most firms have at least one individual working on the Chinese negotiations full time, and visits to China, as often as two to three times per year, are imperative.

On the other hand, if you have a distinct product or service to offer, perhaps the size of your company and the degree of your international experience won't be as important. Above all, you need a firm commitment to all aspects of the JV.

Conclusion

This primer has explored joint ventures with China from a Canadian perspective. It has stressed the importance of careful preparation and the need for expert advice before embarking on a joint business arrangement with the Chinese.

Remember, also, that Canadian companies must compete in a highly dynamic international business environment and that the pace of change in China is now rapid. Priorities within China and the country's response to unfolding global economic and political events are becoming increasingly intertwined.

There are some additional pointers to keep in mind. Be prepared for detailed and protracted negotiations. Be prepared to commit substantial company resources in pursuit of the JV. Use the experiences of others as guidelines. Select your Chinese business partner carefully. Evaluate the respective merits of the contractual, equity and hybrid JV. Take time to become familiar with the Chinese business, political, economic and cultural environments. Evaluate options other than the joint venture. Be aware of the various programs and support available from your federal and provincial governments. (In some cases, such support has been a prerequisite to successfully concluding a major deal with the Chinese.) Above all, approach the Chinese with a good product or service that they really want and your venture will have an excellent chance of success.

In the final analysis, there are no hard and fast rules to follow. Each situation is unique. But after your research has exposed the obstacles and problem areas, you may still find a wealth of opportunity for investment and profit in China. Although there are other options, the joint venture approach is the one officially sanctioned by the Chinese and the one that, in most cases, must be used to get into the country at all.

Remember the maxim ''equality and mutual benefit'' and use it to guide your business dealings in China to success.

Appendix A
Useful Contacts

In Canada

East Asia Trade Development Division (PNC)
Department of External Affairs
125 Sussex Drive
Ottawa, Ontario
K1A 0G2
Tel: (613) 992-7359

Info Export
(toll free): 1-800-267-8376
(In B.C.: 112-800-267-8376)

Export Development Corporation
151 O'Connor Street, P.O. Box 655
Ottawa, Ontario
K1P 5T9
Tel: (613) 598-2500
Telex: 053-4136

Canadian Commercial Corporation
112 Kent St., 17th Floor,
Place de Ville, Tower B,
Ottawa, Ontario
K1A 1E9
Tel: (613) 996-0034
Telex: 053-4359

Embassy of People's Republic of China
511–515 St. Patrick Street
Ottawa, Ontario
K1N 5H3
Tel: (613) 234-2718
Telex: 053-3770

Consulate General of the People's Republic of China
3380 Granville Street
Vancouver, B.C.
V6H 3K3
Tel: (604) 736-4021
Telex: 045-4659

Consulate General of the People's Republic of China
240 George Street
Toronto, Ontario
M5R 2P4
Tel: (416) 964-7260

Industrial Co-operation Division
Canadian International Development Agency
200, promenade du Portage
Hull, Quebec
K1A 0G4
Tel: (819) 997-7901
Telex: 053-4140

China Bilateral Program
Canadian International Development Agency
200, promenade du Portage
Hull, Quebec
K1A 0G4
Tel: (819) 994-3420

Canada-China Trade Council
133 Richmond Street West, Suite 310
Toronto, Ontario
M5H 2L3
Tel: (416) 364-8321
Telex: 06-217598

Canadian Export Association
Suite 250, 99 Bank Street
Ottawa, Ontario
K1P 6B9
Tel: (613) 238-8888

Canadian Manufacturers' Association
One Yonge Street, 14th Floor
Toronto, Ontario
M5E 1J9
Tel: (416) 363-7261

In China

Canadian Embassy
10 San Li Tun
Chao Yang District
Peking
Tel: 52-3536
Cable: DOMCAN PEKING
Telex: 22717 (CANAD CN)

Canadian Consulate General
Union Building, 4th Floor
100 Yan'an Road East
Shanghai
People's Republic of China
Tel: 202822
Telex: 33608 (CANAD CN)

For China

Canadian Commission
Commercial Division
One Exchange Square
Floors 11–14
8 Connaught Place
Hong Kong
Tel: (5) 8906621
Cable: DOMCAN HONG KONG
Telex: (802) 73391 (73391 DOMCA HX)

Appendix B
Provincial Government Contacts

For Information on provincial programs and services:

Alberta
Trade Development Branch
Department of Economic Development
11th Floor, Sterling Place
9940–106th Street
Edmonton, Alberta
T5K 2P6
Telex: 037-2197

Market Development Branch
Alberta Department of Agriculture
3rd Floor, J.G. Donoghue Building
Edmonton, Alberta
T6H 5T6
Telex: 037-2029

British Columbia
Ministry of Industry and Small Business Development
Suite 315, Robson Square
800 Hornby Street
Vancouver, British Columbia
V6Z 2C5
Telex: 04-55459

Manitoba
Trade Branch
Department of Industry, Trade and Technology
5th Floor, 155 Carlton Street
Winnipeg, Manitoba
R3C 3H8
Telex: 07-587833

Newfoundland
Department of Development
Atlantic Place, Water Street
P.O. Box 4750
St. John's, Newfoundland
A1C 5T7
Telex: 016-4949

New Brunswick
Marketing and Trade Services Division
Department of Commerce and Development
P.O. Box 6000
Fredericton, New Brunswick
E3B 5H1
Telex: 014-46100

Nova Scotia
Market Development Centre
Department of Development
5151 George Street
P.O. Box 519
Halifax, Nova Scotia
B3J 2R7
Telex: 019-22548

Ontario
International Marketing Branch
Ministry of Industry and Trade
Hearst Block, Queen's Park
Toronto, Ontario
M7A 2E1
Telex: 06-219786

Prince Edward Island
P.E.I. Development Agency
First Street, West Royalty Industrial Park
P.O. Box 1510
Charlottetown, Prince Edward Island
C1A 7N3
Telex: 014-44109

Quebec
Direction Générale de l'expansion des marchés
Ministère du Commerce extérieur
770 Sherbrooke Street West, 6th Floor
Montreal, Quebec
H3A 1G1
Telex: 055-61760

Saskatchewan
Department of Economic Development and Trade
2103–11th Avenue
4th Floor
Regina, Saskatchewan
S4P 3V7
Telex: 071-2675

Appendix C
DRIE Regional Offices

If you have not previously marketed abroad, or if you wish to apply for assistance under the Program for Export Market Development (PEMD), contact any regional trade officer of the Department of Regional Industrial Expansion at the addresses listed below:

Alberta
Department of Regional Industrial Expansion
Cornerpoint Building
Suite 505
10179–105th Street
Edmonton, Alberta
T5J 3S3
Tel: (403) 420-2944
Telex: 037-2762

British Columbia
Department of Regional Industrial Expansion
Bentall Centre, Tower IV, Suite 1101
1055 Dunsmuir Street
P.O. Box 49178
Vancouver, British Columbia
V7X 1K8
Tel: (604) 666-0434
Telex: 04-51191

Manitoba
Department of Regional Industrial Expansion
185 Carlton Street
P.O. Box 981
Winnipeg, Manitoba
R3C 2V2
Tel: (204) 949-4090
Telex: 07-57624

New Brunswick
Department of Regional Industrial Expansion
Assumption Place
770 Main Street
P.O. Box 1210
Moncton, New Brunswick
E1C 8P9
Tel: (506) 388-6400
Telex: 014-2200

Newfoundland
Department of Regional Industrial Expansion
Parsons Building
90 O'Leary Avenue
P.O. Box 8950
St. John's, Newfoundland
A1B 3R9
Tel: (709) 772-4884
Telex: 016-4749

Northwest Territories
Department of Regional Industrial Expansion
Precambrian Building
P.O. Bag 6100
Yellowknife, Northwest Territories
X1A 1C0
Tel: (403) 920-8568 or 8571

Nova Scotia
Department of Regional Industrial Expansion
1496 Lower Water Street
P.O. Box 940, Postal Station "M"
Halifax, Nova Scotia
B3J 2V9
Tel: (902) 426-2018
Telex: 019-22525

Ontario
Department of Regional Industrial Expansion
1 Front Street West
4th Floor
Dominion Public Building
Toronto, Ontario
M5J 1A4
Tel: (416) 973-5000
Telex: 065-24378

Prince Edward Island
Department of Regional Industrial Expansion
Confederation Court Mall
134 Kent Street, Suite 400
P.O. Box 1115
Charlottetown, Prince Edward Island
C1A 7M8
Tel: (902) 566-7400
Telex: 014-44129

Quebec

Department of Regional Industrial Expansion
Stock Exchange Tower
800 Victoria Square, Suite 4328
P.O. Box 247
Montreal, Quebec
H4Z 1E8
Tel: (514) 283-8185
Telex: 055-60768

Saskatchewan

Department of Regional Industrial Expansion
6th Floor
105–21st Street East
Saskatoon, Saskatchewan
S7K 0B3
Tel: (306) 975-5314
Telex: 074-2742

Yukon

Department of Regional Industrial Expansion
Suite 301
108 Lambert Street
Whitehorse, Yukon
Y1A 1Z2
Tel: (403) 668-4655

Appendix D
Map

External Affairs
Canada

Affaires extérieures
Canada

Canada